

Message Text

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ACTION ARA-10

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-07 FRB-01

INR-07 NSAE-00 USIA-15 TRSE-00 XMB-04 OPIC-06 SP-02

CIEP-02 LAB-04 SIL-01 OMB-01 AGR-10 FEA-01 PA-02

PRS-01 /080 W

----- 023729

R 181450Z SEP 75

FM AMEMBASSY BRASILIA

TO SECSTATE WASHDC 1572

INFO AMCONSUL RIO DE JANEIRO

AMCONSUL SAO PAULO

UNCLAS BRASILIA 8195

E.O. 11652: N/A

TAGS: EFIN BR

SUBJECT: INFLATION PICKS UP IN AUGUST: MONETARY AUTHORITIES
REVISE MONETARY CORRECTION

1. SUMMARY: INFLATION PICKS UP IN AUGUST AS THE EFFECTS OF THE JULY FROST ARE REGISTERED IN FOOD PRICES. CONCERNED WITH THE INFLATION-GENERATING POTENTIAL OF THE SYSTEM OF MONETARY CORRECTION ON THE UPWARD PHASE OF INFLATION CYCLE, THE MONETARY AUTHORITIES HAVE REVISED THE MONETARY CORRECTION INDEX BY EXCLUDING SO-CALLED "ACCIDENTAL" PRICE MOVEMENTS. CHANGE WILL AFFECT GOVERNMENT BONDS, HOME MORTGAGES, MAINTENANCE OF WORKING CAPITAL VALUES, AND VALUES OF PHYSICAL ASSETS. WAGE POLICY IS NOT AFFECTED SINCE WAGE INCREASES ARE DEPENDENT ON THE COST-OF-LIVING INDEX. MODIFICATION IS LIKELY TO INCREASE THE FLOW SAVINGS INTO THE PRIVATE SECTOR.
END SUMMARY.

2. INFLATION, AS MEASURED BY THE RIO DE JANEIRO COST-OF-LIVING INDEX, JUMPED BY 3.4 PERCENT IN AUGUST -- THE HIGHEST MONTHLY INCREASE OF THE YEAR.
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THIS YEAR THROUGH AUGUST THE CUMULATIVE RATE OF

INFLATION REACHED 20.5 PERCENT. DURING THE 12-MONTH PERIOD ENDING IN AUGUST, THE RATE OF INFLATION WAS 29.0 PERCENT.

3. THE BULK OF THE AUGUST INFLATION WAS CAUSED BY RISING FOOD PRICES WHICH RESULTED MAINLY FROM THE JULY FROST. THE FOOD COMPONENT OF THE INDEX ROSE/BY 4.7 PERCENT DURING THE MONTH.

4. BEGINNING WITH THE AUGUST, ADJUSTMENT, THE MONETARY AUTHORITIES HAVE CHANGED THE SYSTEM OF MONETARY CORRECTION, ELIMINATING FROM THE MONETARY CORRECTION INDEX (WHICH IS THE WHOLESALE PRICE INDEX OF PRODUCTS FOR DOMESTIC USE) SO-CALLED "ACCIDENTAL" PRICE MOVEMENTS. FINANCE MINISTER SIMONSEN USED AS EXAMPLES OF "ACCIDENTAL" PRICE MOVEMENTS THOSE RESULTING FROM THE JULY FROST AND OPEC OIL PRICE INCREASES. USING THIS NEW CONCEPT, THE AUGUST MONETARY CORRECTION FACTOR WAS MEASURED AT 1.4 PERCENT, WHILE THE WHOLESALE PRICE INDEX OF PRODUCTS FOR DOMESTIC USE REGISTERED AN INCREASE OF 2.9 PERCENT. IN ORDER NOT TO THROW THE MONETARY CORRECTION FACTOR TOO MUCH OUT OF PHASE WITH INFLATION, THE AUTHORITIES HAVE PLACED A LIMIT OF 4 PERCENT ON THE DIFFERENCE BETWEEN MONETARY CORRECTION AND INFLATION DURING ANY TWELVE-MONTH PERIOD. THE LATEST CHANGE WILL AFFECT MAINLY GOVERNMENT BONDS (ORTNS), THE CORRECTION FACTOR FOR ADJUSTING HOME MORTGAGES, THE MAINTENANCE OF WORKING CAPITAL VALUES AND VALUES OF PHYSICAL ASSETS. WAGE POLICY WILL NOT BE MODIFIED SINCE WAGE INCREASES ARE DEPENDENT ON CHANGES IN THE COST-OF-LIVING INDEX.
COMMENT

4. THE APPARENT REASON FOR THE MODIFICATION OF THE SYSTEM OF MONETARY CORRECTION IS THAT THE MONETARY AUTHORITIES HAD RECENTLY BECOME CONCERNED WITH ITS INFLATION-GENERATING POTENTIAL, PARTICULARLY WHEN INFLATION IS ON THE UPWARD PHASE OF THE INFLATION CYCLE WITH THE CONTRIBUTING FACTORS BEYOND THE CONTROL OF THE MONETARY AUTHORITIES. IN INTRODUCING THIS CHANGE, FINANCE MINISTER SIMONSEN HAS ACCEPTED THE POSITION OF FORMER
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FINANCE MINISTER BULHOES, THE FATHER OF MONETARY CORRECTION, WHO HAS BEEN SAYING FOR SOME TIME THAT THE SYSTEM OF MONETARY CORRECTION IS A MONETARY PHENOMENON AND AS SUCH SHOULD REFLECT THE BEHAVIOR OF MONETARY AND NOT "ACCIDENTAL" FACTORS. THE CRITICS WHO HAVE OPPOSED THYI HANGES, ON THE OTHER HAND, MAINTAIN THAT THE DISTINCTION BETWEEN THE PRICE EFFECTS OF THE MONETARY PHENOMENON AND AN "ACCIDENTAL" PHENOMENON IS REALLY AN

ARBITRARY ONE, REQUIRING SUBJECTIVE JUDGMENTS.
IN ADDITION, THE CRITICS ARQUE THAT
THE GOAL OF MONETARY CORRECTION IS TO
NEUTRALIZE THE EFFECTS OF INFLATION REGARDLESS OF THE
ORIGIN, AND THAT TH E LATEST REVISION REPRESENTS
A DEPARTURE FROM THE ORIGINAL PHILOSOPHY OF
THIS CONCEPT.

5. WHY HAVE THE MONETARY AUTHORITIES AGREED TO MAKE
THIS MODIFICATION AT THIS TIME? ONE EXPLANATION MAY BE THAT
THEY FEARED A REPETITION OF THE DIFFICULTIES CAUSED BY
MONETARY CORRECTION DURING 1974 WHEN INFLATION WAS ALSO
ON THE RISE. FOR INSTANCE, DURING 1974 THERE WERE
AN UNUSUALLY LARGE NUMBER OF MORTGAGE DEFAULTS AS
PEOPLE'S REAL INCOMES WERE BEING SQUEEZED BY INFLATION
WHILE MORTGAGE PAYMENTS WERE GOING UP WITH INFLATION.
ANOTHER PROBLEM WITH MONETARY CORRECTION LAST YEAR WAS
A SHIFT IN SAVING FLOWS TOWARD ASSETS WITH POST-FIXED
MONETARY CORRECTION, SUCH AS GOVERNMENT BONDS, AND AWAY
FROM ASSETS WITH A PRE-FIXED CORRECTION, SUCH AS TIME
DEPOSITS AND BILLS OF ACCEPTANCES.

6. WITH THE LAST ADJUSTMENT IN PLACE, THE GENERAL
EXPECTATION IS THAT A LARGER PORTION OF THE SAVINGS
WILL NOW FLOW INTO THE PRIVATE SECTOR WHERE THE INTEREST
RATES (SUCH AS ON BILLS OF ACCEPTANCE AND TIME DEPOSITS)
ARE FREE TO FLUCTUATE. IT SHOULD BE NOTED, HOWEVER,
THAT THIS REDIRECTION OF SAVINGS IS CONSTRAINED BY
THE INTEREST RATE LIMITS BY THE CENTRAL BANK ON
LOANS MADE BY FINANCIAL INSTITUTIONS. THE AUTHORITIES
ARE, THEREFORE, TAKING SOME RISK BY HAVING A MONETARY
CORRECTION FACTOR WHICH IS LOWER THAN INFLATION BECAUSE
THIS MAY INDUCE SOME SAVERS TO PLACE A LARGER PORTION OF
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THEIR FUNDS INTO SPECULATIVE INVESTMENTS, SUCH AS LANDS
TO THE DETRIMENT OF PRODUCTIVE INVESTMENT. COGNIZANT
OF THIS POSSIBILITY, THE AUTHORITIES PLACED A 4 PERCENT
LIMIT ON THE DIFFERENCE BETWEEN INFLATION AND MONETARY
CORRECTION DURING ANY TWELVE-MONTH PERIOD, HOPING, THAT
THIS WOULD NOT LEAD TO A "FLIGHT FROM THE CRUZEIRO."
JOHNSON

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: INFLATION, ECONOMIC CONDITIONS, CURRENCIES
Control Number: n/a
Copy: SINGLE
Draft Date: 18 SEP 1975
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: n/a
Disposition Approved on Date:
Disposition Authority: n/a
Disposition Case Number: n/a
Disposition Comment:
Disposition Date: 01 JAN 1960
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1975BRASIL08195
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D750324-0633
From: BRASILIA
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1975/newtext/t19750937/aaaabgir.tel
Line Count: 161
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION ARA
Original Classification: UNCLASSIFIED
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 3
Previous Channel Indicators: n/a
Previous Classification: n/a
Previous Handling Restrictions: n/a
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: RowellEO
Review Comment: n/a
Review Content Flags:
Review Date: 10 JUN 2003
Review Event:
Review Exemptions: n/a
Review History: RELEASED <10 JUN 2003 by MaustMC>; APPROVED <05 FEB 2004 by RowellEO>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
06 JUL 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: INFLATION PICKS UP IN AUGUST: MONETARY AUTHORITIES REVISE MONETARY CORRECTION
TAGS: EFIN, BR
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 06 JUL 2006